# Citizens Finance Review Commission



# Minimum Income Tax on C-corps., S-corps. and Limited Liability Companies

**Prepared for the Citizens Finance Review Commission**

**by**

**Income Tax Research Committee**
**Anne Mariucci, Chair**

**and**

**Authors:**
**James Barash, Manager at KPMG LLP**
**Patrick Derdenger, Partner of Steptoe & Johnson LLP**
**Barbara Dickerson, Director at Deloitte & Touche LLP**
**David Downs, Principal Tax Analyst of Salt River Project**
**Amy Etzkorn, Assistant Vice President Tax of AdvancePCS**
**Karen Jacobs, Senior Economist of the Department of Revenue**
**Georganna Meyer, Chief Economist of the Department of Revenue**
**Dana Naimark, Assistant Director of the Children's Action Alliance**
**Susan Kimsey Smith, Esq. of Olsen-Smith, Ltd.**

**This paper is the result of the collaborative efforts of many people. This paper is not, however, representative of the views of all or even a consensus of the committee members and the critical reviewers. To attribute any author with the various positions taken in this paper would be misleading. Rather, the authors attempted to disclose as fully and succinctly as possible the various different opinions and literature on any given topic to aid the CFRC in its deliberations.**

**August 22, 2003**

**Critical Reviewers:**

Dan Anderson
Assistant Executive Director for Institutional Analysis
Arizona Board of Regents

Catherine F. Connolly
Executive Director
League of Arizona Cities and Towns

Dennis Hoffman, Ph.D.
Associate Dean, Graduate Programs
W. P. Carey MBA
Arizona State University

Elliott D. Pollack
President
Elliott D. Pollack & Co.

Jim Rounds
Economist
Elliot D. Pollack & Co.



This report was prepared for the Citizens Finance Review Commission with funding and/or assistance from the Arizona Department of Commerce and the Commerce and Economic Development Commission, and may be presented independently elsewhere at the authors' discretion. This report will be available on the Internet for an indefinite length of time at www.azcfrc.az.gov. Inquiries about this report or the Citizens Finance Review Commission should be directed to the Office of the Governor of Arizona, (602) 542-7601.

1. **What it is**:

Every corporation subject to the Arizona Income Tax Act of 1978 that engages in a trade or business or has income from the state must file an Arizona corporate income tax return. This includes C-corporations, Limited Liability Companies (LLC) classified as corporations, and S-corporations taxed under Subchapter S of the Internal Revenue Code. C-corporations and LLCs file Form 120 income tax return and S-corporations file Form 120S.

A corporation generally is an organization formed under state, federal or foreign corporation laws, having shareholders, directors, officers and limited liability. A corporation is an entity distinct from its shareholders. How a corporation is taxed depends on whether it is a C-corporation or an S-corporation. A C-corporation is any corporation that is not an S-corporation. C-corporations are subject to income tax on their taxable net income.

An eligible corporation may elect to be taxed as an S-corporation. Pass-through of tax attributes and limited liability are available to S-corporations. An S-corporation is generally exempt from federal and Arizona corporate level income tax. Instead, the corporation's income, loss, deduction and credit are passed through to, and taken into account by, its shareholders in computing their individual tax liabilities. S-corporations are subject to many restrictions, including restrictions on the number and kind of shareholders, which do not apply to limited liability companies.

Some S-corporations may be subject to one or more of federal corporate-level taxes on recognized built-in gains, excess net passive income, LIFO recapture, capital gains attributable to certain substituted basis property, and recapture of investment credit (if S election was made before 1987).

Limited liability companies (LLCs) are a creation of state law. LLCs are owned by members, who aren't personally liable for the LLC's debts or obligations. Under the federal "check-the-box" entity classification rules, if an LLC isn't mandatorily classified as a corporation, it may elect to be classified for tax purposes either as a partnership or as a corporation. If an LLC is characterized as a corporation for federal tax purposes, the limited liability company will be treated as a corporation for Arizona income tax purposes since Arizona conforms to federal. A single member LLC is an exception. A single member LLC, if it does not elect to be treated as corporation, is treated as not having any entity status (a disregarded entity). A single member LLC treated as a disregarded entity is not subject to filing a tax return and included in the members return like a division or branch.

Currently, the net income of taxpayer that files Form 120 is subject to an Arizona tax rate of 6.968% or a minimum tax of $50. For Arizona income tax purposes, the minimum tax is applied once on the return. The filing is treated as a single taxpayer.

There are three methods of filing corporate income tax returns to Arizona - are separate company, combined and consolidated.

A corporation files on a separate company (separate entity) basis if it is not part of a group of corporations comprising a unitary business or it is not a member of an affiliated group that elects to file a consolidated return.

A unitary group of corporations files a combined return. A unitary business comprises those parts and components whose functions are integrated and interdependent at the basic operational level. The entities comprising the unitary business must be owned or controlled directly or indirectly by the same interests that collectively own more than 50 percent of the voting stock. When a unitary business comprises more than one corporation, Arizona requires a combined return, unless the affiliated group elects to file a consolidated return.

A common parent of an affiliated group of corporations that files a federal consolidate return may elect to file an Arizona consolidated return. The Arizona gross income of an affiliated group is the consolidated federal taxable income of the affiliated group.

S-corporations are subject to income tax <u>only if</u> they have income subject to tax at the corporate level on the federal Form 1120S. The Arizona tax is 6.968% of net income or a minimum of $50. The S-corporation is subject to the $50 minimum tax <u>only if</u> it has income subject to tax at the federal level. Most S-corporations do not have income subject to tax at the federal level and are thus not subject to the Arizona minimum tax.

The proposal before this commission is increasing the minimum tax on corporations from $50 to $200. The minimum tax amount of $200 was selected as an amount in the mid-range of comparison states for competitiveness and does not represent any relationship to the cost of administering the returns. This proposal also assumes that Arizona will not change its approach of applying the tax to a return as a single taxpayer and not to each entity included in the return.

## 2. **How it would be administered**:

The minimum tax is collected with the filing of the corporate income tax return or the filing of an extension by the original due date of the return. The tax is transmitted either by check or electronic funds transfer to the State.

The administration process does not change with an increase in the amount of the minimum tax.

## 3. **Impact on Existing Revenue Systems**:

We do not expect the increase in the minimum tax to directly affect other revenue systems nor have a secondary affect on other current revenue sources.

Income tax revenues flow into the state's general fund and are shared with cities and towns. An increase in revenue with an increase to the minimum tax on C-corporations, LLCs classified as corporations and S-corporations, will increase the shared revenue to the cities and towns.

4. **Cost**:

The cost of administering the increase to the minimum corporate tax would be nominal because the mechanisms for collecting and processing the tax are already in place.

We believe the compliance cost to corporate taxpayers would be nominal as a minimum tax is already required and the preparing and remitting processes remain the same.

Should Arizona deviate from its current approach, the cost to administer the tax and the cost for the taxpayer to comply could increase more than nominally. As an example, if the minimum tax was applied to each corporation included in the combined or consolidated return, the cost to the taxpayer could increase sharply.

5. **Policy Considerations**:

**A. Equity**

A minimum tax is evenly applied across all corporate taxpayers in horizontal equity. The tax is regressive for vertical equity where taxpayers with little, zero or negative net income pay a disproportionate rate.

**B. Economic Vitality**

Arizona is one of six states among the 10 comparison states to apply a minimum corporate income or similar tax such as franchise, business and occupation, net worth, or excise tax. The six states are Arizona, California, Georgia, New Mexico, Oregon and Utah with a minimum tax of $50, $800, $10, $50, $10 and $100, respectfully.

California applies its franchise minimum tax to each corporation included in a unitary combined return that is incorporated, organized, qualified to do business, registered to do business or doing business in the state of California. The tax must be paid whether the corporation is active, inactive or operates at a loss. Thus, California minimum tax is per entity and not per return.

Georgia's minimum net worth tax is a graduated rate of $10 to $5,000. Net worth is defined to include issued capital stock, paid in surplus and retained earnings.

New Mexico recognizes the same three corporate income tax reporting methods as Arizona – separate entity, combined unitary group and consolidated. Every corporation must pay the $50 minimum franchise tax if it transacts business in, into or from New Mexico, derives income from property or employment within New Mexico, has or exercises its corporate franchise in New Mexico (whether engaged in active business or not) or is an otherwise tax-exempt corporation with unrelated business income. Every corporation that is a member of a combined unitary group or a member of a consolidated group meeting any one of the requirements must pay the $50 minimum franchise tax. Thus, New Mexico minimum tax is per entity and not per return.

Every C-corporation incorporated in Utah, qualified in Utah, or doing business in Utah, whether qualified or not, must file a corporate franchise tax return. Utah applies the minimum franchise tax of $100 for each corporation included in the filing,regardless of whether the corporation exercises its right to do business. Thus, Utah minimum tax is per entity and not per return.

## C. Volatility

The level of revenue raised by the corporate minimum tax is mildly volatile as it is subject to economic swings, net profits or other business climate factors. It is based on entities subject to filing a return with little or no net income. In economic times where businesses incur net operation losses, there may be a higher incidence of minimum tax collections. In better economic times, businesses that become profitable will pay taxes in excess of the minimum. A number of the entities that currently pay the minimum tax are dormant or have little activities that are not affected by the economic climate. The revenue related this portion should be more consist and less volatile.

For the 7-year period of 1994 to 2000, the average C-corporation filers with zero or negative income is 48% of all filers. This indicates that the volatility is mild.

| Year | # of C-Corp Filers w/ $0 or Negative Income | Total C-Corp Filers | Percent of w/ $0 or Negative Income Filers | |
|---|---|---|---|---|
| 1994 | 20,261 | 41,760 | 48.5% | |
| 1995 | 20,700 | 42,498 | 48.7% | (Estimate) |
| 1996 | 20,953 | 42,986 | 48.7% | |
| 1997 | 24,447 | 53,980 | 45.3% | |
| 1998 | 25,750 | 53,997 | 47.7% | |
| 1999 | 26,231 | 53,773 | 48.8% | |
| 2000 | 26,485 | 52,622 | 50.3% | |
| Average | 23,547 | 48,802 | 48.2% | |

For the 7-year period of 1994 to 2000, the percentage of C-corporation filers paying the minimum tax is 66% of all filers. This indicates that the volatility is mild with a slightly increasing trend.

| Year | Number of C-Corp Filers $50 minimum tax | Total C-Corp Filers | Percent of C-Corp Filers $50 minimum tax |
|---|---|---|---|
| 1994 | 26,711 | 41,760 | 64.0% |
| 1995 | 26,621 | 42,498 | 62.6% |
| 1996 | 26,432 | 42,986 | 61.5% |
| 1997 | 36,250 | 53,980 | 67.2% |
| 1998 | 36,275 | 53,997 | 67.2% |
| 1999 | 36,430 | 53,773 | 67.7% |
| 2000 | 36,387 | 52,622 | 69.1% |
| Average | 32,158 | 48,802 | 65.9% |

### D. Simplicity

We believe the application of the corporate minimum tax is simple and straightforward under the current approach.

## 6. **Economic Impact**:

For the 2000 tax year, there were 69% of corporate returns, Form 120, filed with the minimum tax of $50. In the same year, 0 % of the S-corporate returns, Form 120S, were filed with the minimum tax. The following chart presents the increase in annual revenue of $5.46 million should the minimum be increased from $50 to $200 based on 2000 filing results.

| Return Type | Returns w/ Minimum Tax | Total Returns | Percent w/ Minimum Tax | $50 Minimum Tax Revenue | $200 Minimum Tax Revenue | Revenue Increase |
|---|---|---|---|---|---|---|
| C-Corp | 36,387 | 52,622 | 69% | $1,819,350 | $7,277,400 | $5,458,050 |
| S-Corp | 0 | 50,973 | 0% | $0 | $0 | $0 |
| Totals | 36,387 | 103,595 | 35% | $1,819,350 | $7,277,400 | $5,458,050 |

The economic impact could not be determined should Arizona change the approach to applying the minimum tax to each entity included in the filing rather than applying the minimum tax to each return filed,

7. **Other**:

Arguments for increasing the minimum tax to $200 are the following:

- It requires few changes to the existing processes.
- It is simple to apply and administer, and for taxpayers to comply.
- It will offset administrative costs of the corporate income tax filings.

Arguments against increasing the minimum tax to $200 are as follows:

- The minimum tax would exceed all comparison states except for California for single taxpayers.
- The tax is regressive as it is applied to entities that have none or negative earnings.
- Should Arizona apply the tax to each entity in the filing, the cost to the taxpayer may increase sharply.